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RUEHSG/AMEMBASSY SANTIAGO PRIORITY 0556
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RUCPDOG/USDOC WASHINGTON DC PRIORITY

UNCLAS BUENOS AIRES 001313

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TREASURY FOR CLAY LOWERY, NANCY LEE, AJEWEL, WBLOCK, LTRAN
NSC FOR JOSE CARDENAS, ROD HUNTER
PASS FED BOARD OF GOVERNORS FOR RANDALL KROSZNER, PATRICE
ROBITAILLE
PASS EXIM BANK FOR MICHELE WILKINS
PASS OPIC FOR JOHN SIMON, GEORGE SCHULTZ, RUTH ANN NICASTRI
USDOC FOR 4322/ITA/MAC/OLAC/PEACHER

E.O. 12958: N/A

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SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, JUNE 28 -
JULY 5, 2007

REF: BUENOS AIRES

11. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period June 28 - July 5, 2007. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

-- Argentina's Country Risk Premium Hits Highest Level in 2007
-- FDI Flows to Argentina Slows to \$624 Million in Q1 2007
-- Moody's calls on GoA to Adjust its Economic Policies
-- Survey Highlights Private Sector Concerns about GoA Corruption

Banking and Finance

Argentina's Country Risk Premium Hits Highest Level in 2007

12. (SBU) On June 27, Argentina's sovereign risk premium over equivalent maturity U.S. Treasuries, as measured by JP Morgan's EMBI index (Emerging Market Bond Index), reached 320 basis points, the highest value during the year. The index

has widened by 136 basis points compared to the end of January, when it reached a historical minimum of 184 basis points. The increase in the index, reflecting the fall in Argentine bond prices, was driven by several international and domestic factors. Internationally, the uncertainty around the U.S. economy and FED policy has generated higher volatility in capital inflows to emerging markets. Domestically, concerns about economic growth due to the effect of recent energy shortages are a key factor in explaining the poor performance of Argentine bonds. Other areas of concern are the high level of capacity utilization of many industrial sectors, increasing inflationary pressures (exacerbated by perceived GoA manipulation of inflation statistics), declining fiscal surplus (due to high expenditures), coupled with the normal uncertainty that generally accompanies an election year. (Note: the EMBI index includes only dollar-denominated bonds issued under international law. In the case of Argentina, it includes the Par and Discount bonds issued during the 2005 debt restructuring.)

Economic Outlook

FDI Flows to Argentina Fall to \$624 Million in Q1 2007

13. (SBU) The GoA's statistical agency, INDEC, reported June 22 that preliminary FDI flows to Argentina were \$624 million in the first quarter of 2007, 54% lower than in the same period last year. Local analysts were cautious to note that a three-month performance is not sufficient to identify a trend. However, local think tank Fundacion Mercado considers

that uncertainly related to the October presidential elections and the energy shortages are decelerating growth, which translates to decelerating investment and FDI. Another prominent think tank, FIEL, explains the decrease in FDI flows as a result of the private sector's lack of trust in government policies and the constantly changing rules of the game in terms of taxes, regulation, and prices.

14. (SBU) An economist from Banco Provincia (second largest public-owned bank) gives an opposing view, arguing that the reduction in FDI is mainly explained by strong dividend outflows for \$374 million (based on INDEC data). Similarly, an Embassy contact at INDEC explained that the preliminary FDI figure for the first quarter was affected by the timing in the transfer of dividends to parent companies overseas and the payment of inter-company debts. This official argued against projecting that FDI has decreased by half just based on first quarter data, and predicted that FDI flows would adjust in future quarters. (Note: the May 18 Review reported FDI flows to Argentina of \$4.8 billion in 2006, 4% lower than in 2005, based on an ECLAC publication. However, on June 22, the GoA revised both 2005 and 2006 FDI numbers upwards, with \$5.3 billion in 2005, increasing 4% to \$5.5 billion in 2006.)

Moody's Calls on GoA to Adjust its Economic Policies

15. (SBU) During a July 2 conference in Buenos Aires, Moody's VP and Senior Credit Officer Mauro Leos stated that Argentina will have to adjust its policies after the October presidential elections, given that the post-crisis expansion phase is wearing out. He stated that the next administration will face serious challenges with inflation, energy shortages, and growing primary expenditures. In his presentation, he argued that Argentina's high growth rate was explained mainly by high commodity prices and international liquidity, as well as by the severity of the preceding crisis (2001/02) and the GoA's expansionary fiscal and monetary policies.

16. (SBU) Leos acknowledged that Moody's foreign currency sovereign rating of B3 (six levels below investment grade) is worse than Standard and Poor's B (four levels below investment grade) and Fitch's B (five levels below investment grade). However, he argued that Moody's rating methodology

takes into account quantitative and qualitative factors beyond the normal measurements of the strength of macro economic fundamentals. These include the capacity and willingness to pay debts and the country's reaction under stress. As an example, he noted Argentina's breach of gas export contracts with Chile as demonstrating that under stress the GoA will always favor domestic economic interests over those of foreign creditors and consumers, regardless of what domestic or international agreements it may have entered into, and also heedless of the resulting impact on its international reputation. He also pointed to Argentina's refusal to pay its debts to Paris Club member countries, despite clear evidence of ability to pay (record-level official reserves and strong fiscal surplus), as a reason for Argentina's relatively low credit rating (and constraint to increasing it).

¶7. (SBU) Daniel Ruas, Moody's Country Manager for Argentina, noted the possibility of corporates having higher ratings than the sovereign government. Moody's introduced the concepts of ceiling ratings, which are like overall country ratings that assess the probability government interference

in the capacity of other economic agents to repay their debt.

This is different from the government bond rating, which reflects the risk that a government may default on its own obligations. Therefore, Moody's could issue a corporate rating -- reviewing a company's financial strength -- that is higher than the sovereign debt rating, but equal to or lower than the overall country ceiling/guideline. (As an example, in June Moody's rated a local currency bond issued by Banco Hipotecario -- a private-owned domestic bank -- at Aa1, significantly higher than the B3 local currency rating of the GoA.)

Survey Highlights Private Sector Concerns about GoA Corruption

¶8. (SBU) El Observador, a supplement to the Argentine Sunday paper Perfil, published a survey of Argentine private sector opinions on corruption in Argentina and government intervention in the economy. Out of the 200 executives interviewed for the report, six out of ten believe there is a high level of corruption in Argentina, and 87% believe scandals such as the one involving the Swedish construction firm Skanska (over allegations of front companies, fake billing, and bribes, related to a state-run pipeline project) is "normal" for the current administration. While most surveyed did not consider corruption much worse than during President Menem's administration, a strong majority considers government intervention in the economy to be worse, and many advocated for a significantly smaller government. Provided below are the primary results of the survey.

¶A. 87% believe Skanska-like corruption cases are typical for this government, with only 3% considering the Skanska case "an exception."

¶B. 59% believe there is a high level of government corruption, and a further 31% believe there is a medium level of corruption. Only 1% thought that corruption was minimal.

¶C. 51% said the government was responsible for most cases of corruption, with 19% blaming companies, 12% blaming the Judiciary, and 11% blaming unions.

¶D. 45% believe that government pressure on the media is the main reason why more corruption cases are not made public, with another 20% arguing that corruption is the status quo, so ignored by the public.

¶E. Over 50% argue that the judicial system and media are the main actors to combat corruption, with only 15% arguing that the government should be the key actor.

¶F. 70% associate corruption with the style of government in Argentina, with 22% arguing it is a cultural characteristic (Note: El Observador considers this figure significant, as it indicates that most executives do not believe that institutions -- or lack of them -- are to blame, rather the "values" of government leaders are the critical ingredient.)

¶G. Almost 75% believe that the main factors that influence or allow the high corruption levels are lack of controls, authoritarianism, structural corruption, and state

intervention.

¶H. In comparison to Menem's administration, over 60% considered regulated prices, inflation, international relations, investment, and salary negotiations to be worse under President Kirchner's government. Only 19% considered corruption worse.

¶I. 70% considered state intervention, judicial uncertainty (lack of rule of law), lack of (GoA) communication, and lack of investment to be the largest problems confronting the private sector in its relations with the government. Small minorities considered inflation (8%) and corruption (5%)

significant in their relations with the GoA.

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